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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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In the Matter of:	)	
	)	
Amendment of Parts 32 and 64 of the	)	
Commission's Rules to Account for	)	CC Docket No. 93-251
Transactions between Carriers and	)	
Their Nonregulated Affiliates	)	

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

SOUTHWESTERN BELL TELEPHONE COMPANY

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CC Docket No. 93-251

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SOUTHWESTERN BELL TELEPHONE COMPANY

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SUMMARY*

The wholesale changes to the existing affiliate transaction rules proposed in the NPRM are a giant step in the wrong direction and constitute unnecessary regulatory burdens at their worst. The NPRM fails to cite any meaningful or factual support for the proposed changes--it merely relies on speculation and what-ifs. The same speculation and what-ifs were just as apparent in the mid-1980s when the industry was commenting on and the Commission was promulgating the current cost allocation and affiliate transaction rules in the Joint Cost Order proceeding. Moreover, the NPRM contradicts the Commission's positions in the Joint Cost Order proceedings and other orders without even addressing the Commission's prior reasoning and decisions. The enormous effort of the Commission and the industry that went into establishing the existing affiliate transaction rules in the Joint Cost Order should not be summarily dismissed. Instead, the Commission should summarily reject the proposals contained in the NPRM because they are unsupported, unnecessary, overly burdensome and costly in terms of implementation and compliance.

The proposals in the NPRM are detrimental to all involved--the Commission, the carriers, the ratepayer and the shareholder. The only group benefitting from the proposal will be carriers' competitors who are not bound by the rules and thus do not have to incur the unnecessary regulatory burdens and cost of trying to comply.

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* All abbreviations used herein are referenced within the text.

The NPRM proposes to greatly limit the prevailing price test, which is currently based on a substantial number of sales to nonaffiliates, by requiring that an arbitrarily set threshold percentage of output to nonaffiliates be met before the test is applicable. Percentages of output have nothing to do with trying to determine the market price; the inquiry should be a substantial number of sales to nonaffiliates as it is under the current rules.

The NPRM further proposes that the third tier of the affiliate transaction hierarchy for services, the fully distributed cost tier, be changed to impose a dual basis test. The NPRM proposes that under the third tier the carrier be required to estimate a fair market value for each service and calculate the fully distributed cost for each service. The carrier would then book the greater of the two as revenue when it provides the service and the lesser of the two as expense when it receives the service. The NPRM fails to give any guidance, other than "use good faith", regarding how the fair market estimates are to be derived. The Commission considered requiring estimates of fair market value for services in the Joint Cost Order proceeding and rejected such a suggestion noting that the estimates would be subjective and difficult to monitor and audit. The NPRM fails to explain why its proposal for estimates will be any less subjective or easier to monitor and audit.

Requiring estimates of fair market value will lead to endless arguments at the Commission about what is the "proper" estimated fair market valuation for a particular service. It makes no sense for the Commission to greatly limit or eliminate a substantiated prevailing price that can be easily monitored and proven by nonaffiliate purchases and replace it with an estimated fair market valuation which is subjective, difficult to monitor and highly contestable ("my estimate is better than your estimate").

Carriers should not be required to incur the expense associated with attempting to establish and defend numerous fair market estimates, particularly when the existing rules have not been shown to be deficient. The result of requiring such estimates will likely be that carriers will determine that for certain services, the expense associated with complying with the regulatory burdens is not worth the benefits received from providing the service. Thus, the ratepayer will lose the economies of scale and contributions to common expenses generated by such services. Requiring carriers to engage in subjective estimates of fair market value and engage in a dual basis test for services was rejected by the Commission in the Joint Cost Order and that decision should not be overturned.

The Commission should also not become involved in the pricing of transactions between the carrier's nonregulated operations and its nonregulated affiliates as the NPRM seemingly invites. The Commission correctly acknowledged in the Joint Cost Order that such matters were beyond its statutory authority and that position was reaffirmed less than eighteen months ago by the Common Carrier Bureau.

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COMMENTS OF
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Southwestern Bell Telephone Company (SWBT), by its attorneys files the following comments in reply to the Federal Communications Commission's (Commission) Notice of Proposed Rulemaking[1] regarding proposed changes to the existing affiliate transaction rules.

The genesis of this NPRM is a mystery. The Commission and the industry expended enormous resources in the mid-1980s developing and implementing the current cost allocation and affiliate transaction rules. The current rules represent a delicate balance between the alleged need to safeguard against cross-subsidization and the need to avoid overly burdensome and inefficient regulation.

The NPRM now suddenly appears and, without giving any factual explanation other than pure speculation, proposes to scrap the affiliate transaction rules which the Commission and the industry have worked so hard to implement. The proposed scrapping of the existing rules is frustrating to the industry not only because of the years of work behind the adoption and implementation

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[1] In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket No. 93-251 (Released October 20, 1993). (NPRM).

of the existing rules but also because the proposed rules are unnecessary, ambiguous, overly burdensome and costly in terms of implementation and compliance.

I. THERE IS NO NEED TO CHANGE THE EXISTING AFFILIATE TRANSACTION RULES.

The proposed rules are a giant step in the wrong direction. Changes in the industry--particularly emerging competition and the adoption of price cap regulation--all point to the need for less regulation of affiliate transaction pricing, not the additional unnecessary regulatory burdens suggested in the NPRM. As recognized in the Depreciation Simplification Docket, with increasing competition the emphasis should be on decreasing and simplifying regulatory burdens for all competitors,[2] not increasing regulatory burdens and costs on a select group of carriers. In the Depreciation Simplification Docket, the Commission recognized that changes in the industry supported the adoption of a simplified methodology for prescribing depreciation rates. In addressing depreciation, the Commission noted that its goals were simplification of the process, administrative savings, and flexibility, while continuing to ensure just and reasonable tariffed rates to the consumers.[3] Price cap regulation and the current affiliate transaction rules already ensure reasonable tariffed rates. Thus, as with the depreciation process, the Commission should be striving toward simplification, administrative

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[2]In the Matter of Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, paras. 14-16, 18-21 (Released October 20, 1993). (Depreciation Simplification Order).

[3]Depreciation Simplification Order, para. 3.

savings and flexibility, not the more onerous and costly rules proposed by the NPRM.

It is ironic that the NPRM proposes a change to a more costly and burdensome methodology when affiliate transactions account for such a small percentage of carriers' business compared to depreciation expense. Even more ironic is the fact that the Commission is imposing a more costly and burdensome methodology for affiliate transactions at the same time the Commission is simplifying the depreciation prescription process which results in the carriers' largest single expense.[4]

The proposed scrapping of the existing rules is made even more frustrating by the fact that the "rationale" given for the changes consists of nothing more than idle speculation and "what-ifs." The frustration is compounded by the fact that the speculation relied on by the NPRM is not new--the speculation and "what-ifs" were just as apparent in the mid-1980s when the current affiliate transaction rules were being debated and promulgated in the Joint Cost Order proceeding.[5] The NPRM simply fails to point to any new rationale or factual experience to justify the change in the rules and the increase in regulatory burdens.

The Joint Cost Proceeding established the current hierarchy as to how the regulated carrier should book costs

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[4]See, Depreciation Simplification Order, para. 27.

[5]Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities and Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to provide for Nonregulated Activities and to Provide For Transactions Between Telephone Companies and Their Affiliates, CC Docket 86-111, 2 FCC Rcd 1298 (1988) (Joint Cost Order); recon. 2 FCC Rcd 6283 (1987 (Joint Cost Recon. Order); Further recon. 3 FCC Rcd 6701 (1988).

associated with affiliate transactions in its regulated accounts. Carriers book the tariffed rate of the asset or service, or in the absence thereof the prevailing price of the asset or service based on a substantial number of similar transactions with nonaffiliated third parties.[6] In the absence of a prevailing price for services, the carrier books the fully distributed cost (FDC) of the service.[7] In the absence of a prevailing price for an asset, the carrier books the greater of fair market value or net book for outbound assets and the lesser of the two for inbound assets.[8]

In addition to the recording requirements, existing Commission safeguards include a broad spectrum of rules, audits and reporting requirements which effectively control affiliate transactions. These safeguards include:

1. Accounting rules and cost allocation standards which include FDC provisions that assure a service contributes to general overhead costs which would otherwise be borne solely by the regulated ratepayer.[9]

2. Requirements to file and update quarterly, cost allocation manuals (CAM) reflecting the established rules and current affiliate and nonregulated transactions.[10]

3. CAM uniformity aimed at facilitating FCC review of local exchange carrier (LEC) CAMs to ensure that they are reasonable and accurate.[11]

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[6]Joint Cost Order, 2 FCC Rcd at 1336; Joint Cost Recon. Order, 2 FCC Rcd at 6295-6298; See also, 47 C.F.R. 32.27.

[7]Id.

[8]Id.

[9]See, 47 C.F.R. 32.27; 47 C.F.R. 64.901; 47 C.F.R. 64.902.

[10]47 C.F.R. 64.903.

[11]See, In the Matter of Implementation of Further Cost Allocation Manual Uniformity, AAD 92-42, Order Inviting Comments, Released October 13, 1992); Memorandum Opinion and Order (Released July 1, 1993).

4. External audits, which include affiliate transactions in their scope, that:

   a) provide the same level of assurance as that provided on a financial statement audit engagement;[12]

   b) render an opinion on whether the carriers' cost allocation methodologies are conforming with the CAM;[13]

   c) render an opinion on whether the results fairly present the results of the company's operations;[14] and

   d) evaluate and report on the carrier's internal controls when auditors rely upon those controls in determining the extent of auditing procedures as required by Generally Accepted Accounting Principles (GAAP).[15]

5. The establishment of detailed reporting requirements and the development of automated reporting through the Automated Reporting Management Information System (ARMIS). ARMIS facilitates benchmarking between the Bell Operating Companies (BOCs), which is further enhanced by the uniformity rules.[16]

6. Performance of on-site audits by the FCC staff.

The affiliate transaction and cost allocation rules and safeguards have been tested and affirmed through numerous Commission orders and actual use for over six years. The current affiliate transaction rules and safeguards were deemed adequate by this Commission in 1987,[17] refined in the various CAM approval

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[12] In the Matter of Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, Report and Order, 6 FCC Rcd. 7571, 7591-7597 (1991). (BOC Safeguards Order).

[13] Id.

[14] Id.

[15] Id.

[16] See Appendix A.

[17] Joint Cost Order, 2 FCC Rcd at 1335-1337. Joint Cost Recon. Order, 2 FCC Rcd at 6293-6298.

orders through 1988,[18] and reaffirmed as working well in 1991 in the conclusion reached in the CI-III Remand Proceedings.[19] In the BOC Safeguards Order the Commission examined the use of the in-depth reporting of individual BOC's actual allocations of costs, as required by the ARMIS reports, and concluded that claims that such reporting would not enable detection of subtle cross-subsidies were unsupported.[20] In addition, the Commission confirmed that it had sufficient resources to monitor the BOC's activities, under the existing rules.[21] The Commission also cited its enforcement actions against NYNEX as an example supporting "the efficacy of our affiliate transaction rules."[22]

SWBT is not aware of any issues that have arisen in the twenty-four months since the release of the BOC Safeguards Order that would warrant a wholesale modification of the existing affiliate transaction rules. If anything, the affiliate transaction rules have been strengthened, not only by the additional audit and reporting requirements resulting from the CI-III Remand, but also by the adoption of price cap regulation, which as the Commission acknowledged in the BOC Safeguards Order,

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[18]See, e.g., In the Matter of NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 3 FCC Rcd 81 (1988). (NYNEX CAM Approval Order); In the Matter of U S WEST's Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 3 FCC Rcd 195, 199 (1988). (U S WEST CAM Approval Order). The Common Carrier Bureau reviewed and issued Orders on each cost allocation manual filed.

[19]BOC Safeguards Order, 6 FCC Rcd at 7591-7597.

[20]BOC Safeguards Order, 6 FCC Rcd at 7595.

[21]Id.

[22]BOC Safeguards Order, 6 FCC Rcd at 7595-96.

"complements" the cost allocation reporting and enforcement safeguards "to reduce BOC incentives to cross-subsidize."[23]

Carrier and Commission resources surely can be spent more appropriately than scrapping an affiliate transaction methodology not shown to be deficient, and developing and implementing a more complicated and costly methodology which will cause inefficiencies without generating public benefits. The NPRM proposals are a step backwards because they scrap the current requirements of recording actual affiliate transactions and replace them with a high level recording of speculative estimates which will be difficult to monitor. The Commission should summarily reject the proposals set forth in the NPRM in their entirety.

II. THE COMMISSION SHOULD NOT SCRAP OR MODIFY THE PREVAILING PRICE RULE.

In the Joint Cost Proceeding the Commission determined that the "prevailing price as established by a substantial number of similar transactions" was an appropriate safeguard against cross-subsidization because it "provided reasonable assurance that the price" would not "be manipulated to the detriment of the ratepayer."[24] The Commission carefully tailored the prevailing price test to assure that it serves as a safeguard against cross-subsidization.[25] For example, during the CAM approval process the Common Carrier Bureau (Bureau) confirmed that the prevailing price must be established by actual sales to nonaffiliated third parties

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[23] BOC Safeguards Order, 6 FCC Rcd at 7577-78.

[24] Joint Cost Recon. Order, 2 FCC Rcd at 6293.

[25] Joint Cost Recon. Order., 2 FCC Rcd at 6295-6297.

at that price, not merely by the offering of the product or service at that price.[26] Thus, the prevailing price test efficiently measures whether the cost is comparable to market value by looking at whether nonaffiliated third parties have purchased the product from the entity at the same price.

The NPRM proposes to scrap the prevailing price test, except in limited circumstances, by looking beyond the prices affiliates pay each other and focusing on the costs the affiliate group incurs in providing affiliate transactions.[27] Such an approach is contrary to the Commission's traditional market based approach and reveals a sharp inconsistency in the NPRM. On the one hand, tariffed rates as established by a state, federal or other valid regulatory agency are deemed reasonable and serve as the pinnacle of the affiliate transaction rule hierarchy because tariff rates act as a surrogate for competitive forces in the marketplace.[28] Ironically though, the NPRM does not perceive a prevailing price established by the competitive forces in the marketplace as a reasonable rate.[29] If a tariffed rate is the regulatory surrogate for a market rate and thus, is the pinnacle of the affiliate transaction rule hierarchy, then logic and practice demands that a rate established in the marketplace through actual sales should be the most accurate of all methods.

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[26] US West CAM Approval Order, 3 FCC Rcd at 199.

[27] NPRM, para. 11.

[28] Joint Cost Order, 2 FCC Rcd at 1336; See also, NPRM, paras. 13-14.

[29] NPRM, paras. 15-19.

A. <u>There Is Nothing About The Affiliate Relationship That Renders The Established Prevailing Price Rule An Inadequate Means To Efficiently Determine Market Price And Serve As A Safeguard Against Cross-Subsidization</u>.

SWBT is bewildered by the statement in the <u>NPRM</u> that "it appears that there may be little correlation between the prices carriers contend are prevailing company prices and the prices carriers or their affiliates would pay if they granted nonaffiliates terms similar to those implicit in the affiliate transaction rules."[30] SWBT is unaware of any determination by the Commission that any carrier has not been following the prevailing price rule as established in the <u>Joint Cost</u> proceeding and refined through the CAM approval process. The <u>NPRM</u> fails to cite a single instance where a carrier has "manipulated" the prevailing price valuation "to the detriment of the ratepayer."[31] Nor is there any reason to suspect such manipulation since affiliates engaged in transactions based on prevailing price are paying the same prices in similar transactions as the nonaffiliates.

The <u>NPRM</u> contends that the marketplace somehow "distinguishes among different supplier/customer relationships" including affiliate to affiliate transactions.[32] The <u>NPRM</u> notes that in a competitive market, companies devote resources to retaining and attracting customers with each competitor's goal to persuade independent entities to pick its goods or services over

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[30]<u>NPRM</u>, at para. 16.

[31]<u>See</u>, <u>Joint Cost Recon. Order</u>, 2 FCC Rcd at 6293; wherein the Commission notes that the prevailing price valuation gives reasonable assurance that the price will not be manipulated to the detriment of the ratepayer.

[32]<u>NPRM</u>, at para. 16.

those of other potential suppliers.[33] The NPRM then assumes, without any factual support, that because affiliates are allegedly under captive control, the selling affiliate does not have to incur the cost of such marketing efforts or offer various incentives.[34]

The NPRM's assumption is flawed because of the fact that the affiliates always have at least three options in the acquisition of resources: 1) buy the service from an affiliate, 2) buy the service from a nonaffiliate, or 3) produce the service internally. The NPRM also ignores the requirement that, in order to rely on the prevailing price test, there must be a substantial number of sales to nonaffiliated third parties.[35] Competing sources of supply generally exist and thus any voluntary transaction with a nonaffiliate must be earned. The assumption that there is a lack of cost in affiliate relationships flies in the face of reality, considering that the market establishes the need for volume discounts and that sales expense, shipping expenses, product warranty and promotion expenses do not somehow miraculously disappear when an affiliate is involved.[36] The affiliate under the prevailing price test receives the same price

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[33]NPRM, at para. 17.

[34]NPRM, at para. 18.

[35]47 C.F.R. 3227; See also, U S WEST CAM Approval Order, 3 FCC Rcd at 199.

[36]The economic reality is that the price is established in the competitive market--costs do not determine those prices. Costs certainly determine profitability or determine the firm's ability to compete in a specific market, but clearly the firm's costs do not determine the prevailing market price. Of course, if the selling affiliate is not competing in the market and thus does not have a substantial number of sales to nonaffiliated entities, the prevailing price valuation is not applicable under the existing rules.

and incentives as does a nonaffiliate and those terms are market driven. If the affiliate transaction did not occur, the affiliate purchasing the good or service would have to purchase from a nonaffiliate who would likewise incur the same marketing effort and other support costs.

The NPRM "questions whether affiliate transactions are sufficiently similar to transactions among nonaffiliates to justify the continued use of prevailing price as a valuation method for affiliate transactions."[37] The Commission answered this question in the affirmative in 1987 in the Joint Cost Order and the answer continues to be yes.[38] The answer is yes because in order to rely on prevailing price, the affiliate must have a substantial number of actual sales to nonaffiliated third parties at that price. There is simply nothing unique about the fact that affiliates are involved to render the prevailing price test inadequate--it is an efficient means of measuring the fair market value of the service.

B. The NPRM's Proposal To Draw Distinctions Among Affiliates Is Unnecessary.

In a needless exercise, the NPRM attempts to establish guidelines for classifying affiliates between those which "have a primary purpose to serve the carrier" and "those which do not."[39] The NPRM then proposes that the prevailing price test would only be available for those affiliates which do not have a "primary purpose" to serve the carrier.[40] Although the NPRM notes that the

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[37]NPRM, para. 18.

[38]Joint Cost Order, 2 FCC Rcd at 1336; Joint Cost Recon. Order, 2 FCC Rcd at 6295-98.

[39]NPRM, paras. 19-20.

[40]NPRM, paras. 21-22.

best way to determine the classification would be to evaluate each nonregulated affiliate's overall operations in detail, which it admits "would be far too onerous,"[41] it proposes to adopt an arbitrary bright line percentage of output test.[42] The NPRM thus concludes its exercise by proposing to preclude the use of the prevailing price test to any affiliate that sells less than an arbitrarily set seventy-five percent of its output to nonaffiliated parties.[43]

The stated purpose of this exercise is to classify those affiliated entities whose "predominant purpose" is to serve nonaffiliates.[44] The exercise is meaningless because the inquiry should be whether a prevailing price for the asset or service has been established through sales in the market, not the relationship between the carrier and the affiliate.

The percentage of output provided to nonaffiliates is irrelevant to the establishment of a prevailing market price, regardless of what percentage is chosen. It is the selling entity's market price--what others are actually paying--which should be the focus of the inquiry. It is the existence of a nonregulated, competitive market for the products and services in question that determines a market price or prevailing price.[45]

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[41]NPRM, para. 21.

[42]NPRM, para. 22.

[43]Id.

[44]Id.

[45]Market price has been defined as "The price at which a seller is ready and willing to sell and a buyer ready and willing to buy in the ordinary course of trade." Black's Law Dictionary, Black, Henry Campbell, 7th Reprint, 1985, Copyright 1979 by West Publishing Co., p. 875.

There is no reason to deny the legitimacy of a prevailing price, established by a substantial number of sales to nonaffiliates, based on the fact that an arbitrary percent of output threshold was not reached.

The proposed classification of affiliates' exercise described in the NPRM is also unnecessary because a more accurate means of distinguishing between affiliates is built into the current "prevailing price" test--a means which more accurately reflects market value. The current "prevailing price" test requires that an affiliate have a substantial number of actual sales of the particular product or service at a particular price before the price can be used as a method of valuation for booking purposes.[46] The rigor of the current test is that it applies on an item by item basis. The fact that the carrier is precluded from using the prevailing price as a method of valuation unless there have been arms length transactions in the form of a substantial number of sales to nonaffiliates at that price is sufficient to satisfy concerns about cross-subsidization. Thus, the concerns expressed by the NPRM allegedly justifying the imposition of classification requirements are already addressed by the existing rules.

III. The Commission Should Not Reverse Its Earlier Decision That FDC Alone Is The Proper Method For Valuing Nontariffed Services For Which A Prevailing Price Cannot Be Established.

Under the current affiliate transaction rule hierarchy, if neither a tariffed rate nor prevailing price is available for a service, the carrier drops to the third tier of the hierarchy and

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[46] U S WEST CAM Approval Order, 3 FCC Rcd at 195.

values the transaction based on FDC.[47] The NPRM proposes to change the third tier of the affiliate transaction rule hierarchy by requiring carriers to calculate both the FDC and "estimated fair market value" for all services not meeting the criteria for the first two tiers.[48] The NPRM further proposes to institute a dual basis test for the third tier whereby the carrier would book the lower of estimated fair market value and FDC for services it receives and the greater of the two for services it provides.[49]

Less than seven years ago this Commission rejected a similar estimated fair market value dual basis test.[50] The Commission should not reverse its previous decision because: A) the proposed estimated fair market valuation test is unnecessary and unworkable, B) there has been no rationale given to support a reversal of the Commission's decision and the imposition of additional regulatory burdens and expense, and C) the imposition of the changes will destroy incentives associated with economies of scope and scale which currently benefit the ratepayer.

A. The Estimated Fair Market Test Was Rightly Rejected As Being Subjective and Difficult to Monitor--Adoption Of An Estimated Fair Market Valuation Weakens Rather Than Enhances The Affiliate Transaction Rules.

In the Joint Cost Order proceeding several parties argued that if a tariff or prevailing price is unavailable as a measure of value, the Commission should look to the estimated value of similar

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[47] 47 C.F.R. 32.27(d).

[48] NPRM, para. 34.

[49] Id.

[50] Joint Cost Order, 2 FCC Rcd at 1334-35; Joint Cost Recon. Order, 2 FCC Rcd at pp. 6296-97.

services in the marketplace as a valuation standard.[51] The Commission rejected such arguments noting that "such a valuation standard is fraught with the potential for abuse, and would be difficult to monitor."[52] The Commission also correctly observed that the "determination of fair market value raises concerns of subjectivity."[53] The Commission concluded that in contrast to estimating fair market value, by requiring carriers and their affiliates to allocate costs pursuant to the cost allocation standards, we can ensure that an auditable measure of the cost of service is available."[54] The NPRM fails to explain why the proposed estimated fair market value test is any less arbitrary, less subjective or easy to monitor than the estimated fair market test previously rejected. The explanation obviously does not lie in the "methodology" for determining the estimated fair market value because no methodology is given in the NPRM.

The NPRM proposes that carriers are to "estimate" the fair market value of all nontariffed affiliate transactions which are not subject to the "prevailing price" valuation.[55] The NPRM fails to give any guidance as to how it expects a carrier to "estimate" fair market value. Instead carriers are told that the

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[51]Joint Cost Recon. Order, 2 FCC Rcd at 6297.

[52]Id.

[53]Joint Cost Order, 2 FCC Rcd at 1335.

[54]Joint Cost Recon. Order, 2 FCC Rcd at 6297. The Commission thus rejected the notion of an "estimated fair market value" and instead relied on a hierarchy of 1)tariffed rate, 2)the prevailing price as established by actual sales to nonaffiliated third parties and finally 3) fully distributed cost noting that all are easily auditable and do not require subjectivity. See, Joint Cost Recon. Order, 2 FCC 2d at 6296-6297.

[55]NPRM, para. 90.

procedures they use "should vary with the circumstances of the transactions."[56] The NPRM proclaims that it does not "intend to specify the precise steps the carriers should include in each particular estimation process."[57] Thus, the only guidance given as to how carriers are expected to comply is that each carrier is expected to attempt "in good faith to determine whether fair market value exceeds cost."[58]

Thus, the estimated fair market value test proposed in the NPRM will be just as arbitrary, subjective and impossible to monitor as the estimated fair market valuation proposed during the Joint Cost Order proceeding. Reams of paper will no doubt be filed by carriers and their opponents arguing over what is the "proper" estimated fair market valuation. Endless hours will be spent by carriers trying to establish and the Commission trying to audit and otherwise monitor the estimated fair market value. Yet the fair market valuation will remain only a subjective, arbitrary estimate and the carriers subject to claims of manipulation no matter how the estimate is developed.

Compounding the inconsistency is the fact that the NPRM proposes to greatly curtail the use of the prevailing price as established by a substantial number of sales to nonaffiliates standard.[59] The NPRM thus limits the use of the second tier test

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[56] Id.

[57] Id.

[58] Id. The lack of an explanation of how carriers are supposed to estimate fair market value also greatly impairs the carriers' ability to comment on the proposal.

[59] NPRM, para. 22.

which was designed,[60] and refined,[61] to assure fair market value, and requires carriers who drop to the third tier of the test to rely on a subjective "estimated fair market value." Why would the Commission limit the use of a workable, established auditable test for determining fair market value which is based on actual transactions in deference to speculative and subjective estimates?

Thus, adopting the proposals set forth in the NPRM weakens rather than enhances the affiliate transaction rules because it severely limits and threatens to eliminate[62] the established auditable prevailing price test, and replaces it at the next tier with an arbitrary and difficult to monitor and audit estimated fair market value test.

B. The NPRM's Suggestion That The Commission Reverse Itself And Require A Dual Basis Test Is Unsupported.

There is no rational support for the NPRM's suggestion that the Commission reverse itself and require a dual basis test based on a comparison of estimated fair market value and FDC. The only change since the adoption of the rules cited in the NPRM as

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[60]Joint Cost Order, 2 FCC Rcd at 1336; Joint Cost Recon. Order, 2 FCC Rcd at 6295-98.

[61]See, Fn. 18 supra.

[62]The NPRM in para. 22 invites comments on whether it "should abandon prevailing company pricing as a valuation method for all affiliate transactions if we find no workable test for determining when prevailing company prices provide reliable measures of how affiliate transactions should be valued." If the Commission were to adopt such reasoning, which would be nonsensical because the prevailing price test has been shown as a reliable measure as noted in previous Commission Orders cited herein, then the proposed estimated fair market test would likewise need to be abandoned as it has already been deemed speculative and difficult, if not impossible, to monitor by the Commission during the Joint Cost Order proceeding and this is even less of a "reliable measure of how affiliate transactions should be monitored."

justifying the change was the adoption of price cap regulation.[63]

The NPRM states that the reason for not applying the dual basis test to services in the Joint Cost Order proceeding was because the rules would reduce or eliminate "the incentive for certain service activities to be provided in a more efficient manner than that which the regulated entity would alone achieve."[64] The NPRM contends that since the affiliate transaction rules took effect, the Commission has "adopted price cap regulatory programs that give AT&T and most large LECs efficiency incentives far stronger than those the valuation methods for affiliate services sought to preserve."[65] The NPRM presents no facts to justify its conclusion that the LEC price cap plan creates more potent incentives for efficient behavior than the LEC affiliate transaction rules. The logic appears to be that because the Commission has correctly increased incentives to be more efficient by introducing price cap regulation, it can retract other incentives to be efficient. Such logic suggests that trends toward better, more efficient regulation may be interrupted by worse, less efficient regulation without justification. The Commission cannot sustain the introduction of costly and burdensome regulatory obligations with such logic.

It is difficult to understand why the existing affiliate transaction rules were adequate under rate of return regulation

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[63]NPRM, paras. 31-32.

[64]NPRM, para. 31; citing, Joint Cost Order, 2 FCC Rcd at 1336. The NPRM fails to note however the Commission's additional concerns about the dual basis test--the speculativeness and unauditability of the estimated fair market valuation. (Joint Cost Order, 2 FCC Rcd at 1335; Joint Cost Recon. Order, 2 FCC Rcd at 6297.)

[65]NPRM, para. 31.

where there was a direct link between cost and prices, but are not adequate under a price cap methodology which was designed to delink prices from costs. Since the FCC's initiation of price cap regulation, changes in LEC costs do not equate to subsequent changes in LEC prices. LEC revenue shortfalls are not automatically offset by increased LEC tariff rates.

Modifications in state regulatory processes have also produced effects similar to those accompanying price cap regulation of LEC interstate operations. Examples are the agreements operating within portions of SWBT's territory that severely constrain basic local exchange service rates.[66] With these severe constraints in the intrastate arena, the remaining method for recovering rising expenses would be through seeking increased rates for those intrastate LEC services (such as intraLATA toll) which are sold in increasingly competitive markets.

Seeking to raise the prices of those services that are encountering competitive pressures does not appear to be a particularly prudent long term business strategy for any LEC, even if the regulators would allow such increases. Thus, it is not likely that a LEC would overpay a nonregulated affiliate because the most likely outcomes are for the LEC to either suffer lower earnings or seek an increase in the prices of its most competitive intrastate service offerings.

The NPRM still speculates, however, that the current third tier FDC test somehow motivates carriers to sell services valued at FDC to their affiliates at less than market value and

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[66] Missouri, Texas, Kansas.